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295 North Maple Avenue
Basking Ridge, NJ 07920

February 19, 1999

Ms. Magalie Roman Salas
Secretary
Federal Communications Commission
445 Twelfth Street, S.W.
Washington, D.C. 20554

RE: Ex Parte Presentation
CC Docket No. 96-45 – Universal Service/Proxy Cost Models
CC Docket No. 96-98 – Interconnection
CC Docket No. 96-262 – Access Reform

Dear Ms. Salas:

On February 17, 1999, I spoke to a group of about 30 members of the Commission staff at a "Brown Bag" discussion session of the Office of Plans and Policy. The subject of my talk was, *Forward-Looking Economic Cost and ILEC Interconnection*. This talk dealt with the appropriate use of TELRIC and forward-looking economic cost for establishing interconnection rates – with particular application to interstate access. In addition, I discussed why proxy modeling is the superior method for computing forward-looking economic costs. A copy of my presentation materials is attached.

Two copies of this Notice are being submitted to the Secretary of the FCC in accordance with Section 1.1206(a)(1) of the Commission's rules.

Sincerely,

Richard N. Clarke | ha

Richard N. Clarke

cc: William Rogerson
Marilyn Simon, OPP

Forward-Looking Economic Cost and ILEC Interconnection

Richard N. Clarke
AT&T - Public Policy
908 221-8685

FCC Brown Bag
February 17, 1999

The opinions expressed in this presentation are mine alone, and do not necessarily represent those of AT&T

Presentation overview

- Review definition of forward-looking economic cost (FLEC)
- Policy implications of using FLEC concept
- Alternative cost concepts
- Methodologies for computing FLEC
- FLEC modeling of carrier access
- Summary

Forward-looking economic cost

- Is the sum of:
  - Forward-looking incremental costs
    - variable costs specific to the item
    - fixed costs that benefit the item
  - "Reasonable" allocation of forward-looking joint and common costs
    - equiproportional: OK
    - monopoly opportunity costs (such as ECPR), subsidies and/or "stranded" costs: not OK
- Is long run
  - Efficient lifecycle configurations and "fill"
  - All short run fixed costs become variable

Forward-looking economic cost

Is designed to represent the cost level that would be experienced by a competitive new entrant with newly constructed facilities if it:

- Operates efficiently using modern technology employed in efficient network configurations
- Serves the total demand for costed item
- Serves customers located in their current positions from wire centers located at their current positions
- Earns a "normal" return

Implications of FLEC assumption

- Embedded network is irrelevant
  - Except for scorched node wire center assumption
  - Assists consistency with recordkeeping and geographical constraints
- "Fantasy" network is not required -- assumes use of only current "best" technologies
- Costs must be those of a network that is efficient for the desired purpose (e.g., broadband costs are broadband's responsibility)

Implications of FLEC pricing

- Provides the correct guidance for:
  - Production decisions having substantial lead times
  - Long-lived investments
  - Markets that are competitive -- or are intended to perform competitively
- Ensures that scale and scope economies are appropriately shared with new entrant rivals

Implications of FLEC pricing

- Single value ensures nondiscrimination in a multi-carrier market
- Administratively, it is the least burdensome on the market participants
- No other compensatory and calculable cost concept supports the development of efficient competition

Other costing methodologies

Historical embedded costs (HEC)

- Calculates costs using historical books of account
- Embodies profile of network designs, efficiency levels, costs and qualities that exist today
- Burdensome/unworkable in a multi-carrier market
- Does not give correct long run price signals

Forward-looking "actual" costs (FLAC)

- Idiosyncratically adjusts historical books/network
- Resulting profile of network designs, efficiency levels, costs and qualities will be inconsistent
- Burdensome/unworkable in a multi-carrier market
- Does not give correct long run price signals

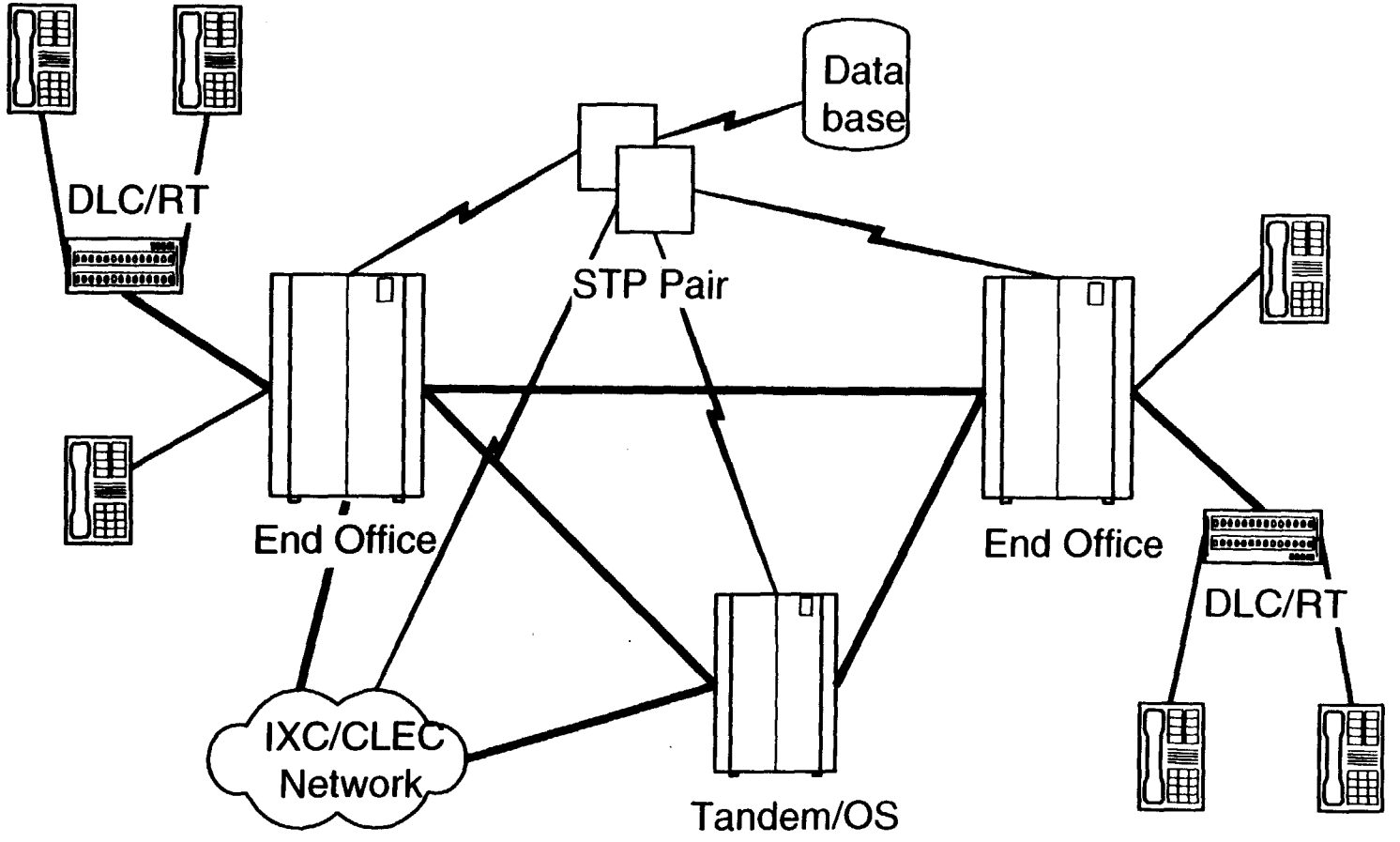
Methods of computing FLEC

- Historical accounting methods, possibly projected forward
- Methods based on current combinations of disaggregated component costs
- Explicit modeling (or "proxying") of the actual cost-generating processes:
  - Engineering-generated
  - Economics-generated

Proxy modeling of FLEC

- Proxy modeling is the superior methodology for computing FLECs because:
  - It can assure consistent modeling of costs across the complete network
  - It addresses consistently the costs of families of interrelated network elements
    - engineering interrelationships are cared for (e.g., switching and loop)
    - assures that joint and common costs are treated consistently across items

Consistency of network components



Proxy modeling of FLEC

Proxy modeling:

- Minimizes data collection requirements and administrative burdens on companies
- Is the only methodology reasonably capable of needed levels of disaggregation
- Provides transparency and rigor to the costing process
  - proprietary data/confidentiality agreements not needed
  - valuable third-party intervention is possible

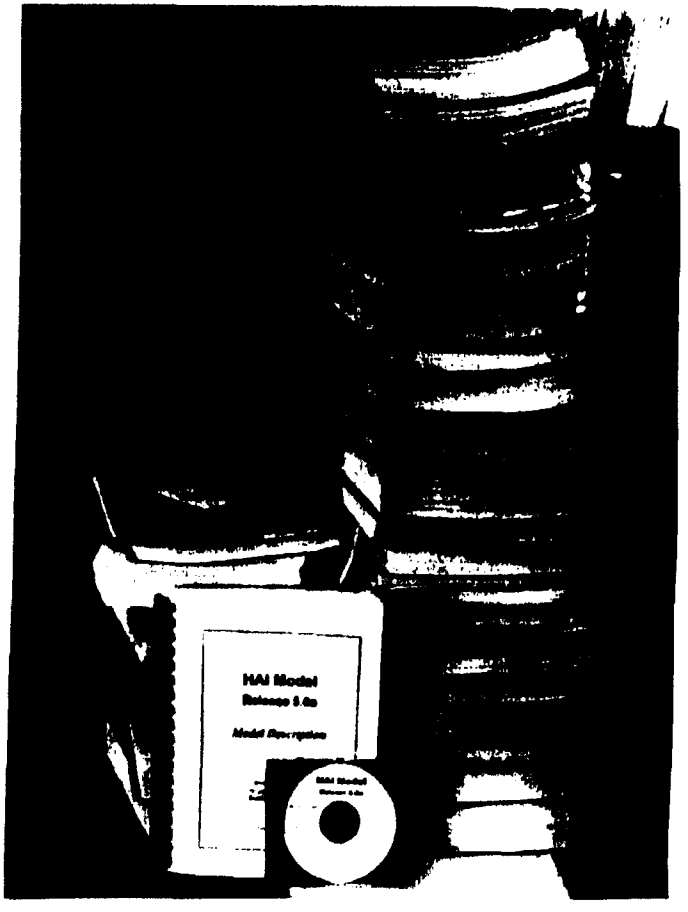
Tranparency comparison

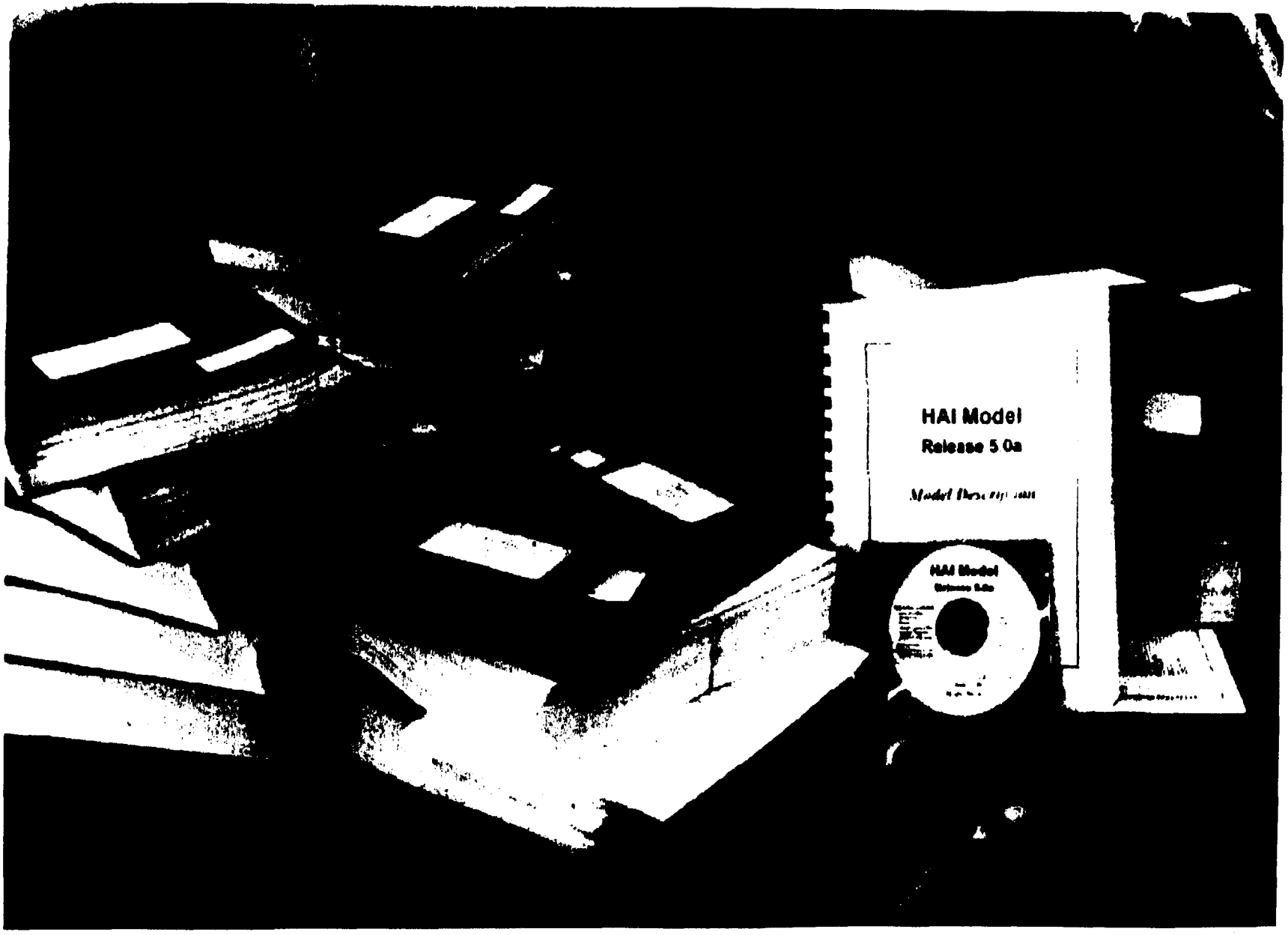
Compare proxy model to GTE "study" of its Texas end office switching costs

- ~15% of GTE-TX total cost
- ~1% of national lines

ILEC cost "studies" are:

- Special purpose in design
- Idiosyncratically executed
- Unintegrated
- Nontransparent




HAI Model
Release 5.0a

Implications for access prices

- Access is interconnection sold to IXCs
- Currently priced based on fully distributed embedded cost per Part 32/64/36/69 accounting and adjusted per price cap regulation
- FLEC can be flexibly and reliably estimated using proxy models of the underlying engineering and economic production processes

Access financials

	Current Charge	Billing Unit	Billed to:	Modeled FLEC	Notes
Loop					
EUCL	$ 4.76	per line/mo	EU	$ 4.00 *	* At 25% interstate allocation
CCL	$ 0.0041	per min	IXC		
PICC	$ 0.98	per line/mo	IXC/EU		
Switching					
LS2	$ 0.0075	per min	IXC	$ 0.0015	
Port		per line/mo	IXC/EU	$ 0.20 *	* At 25% interstate allocation
Transport					
Dedicated	$ 0.0028	per min**	IXC	$ 0.0007	**Actual charge to IXC is per trunk
Common	$ 0.0066	per min	IXC	$ 0.0025	
RIC	$ 0.0007	per min	IXC		
Total	$ 5.74	per line/mo	EU/IXC	$ 4.20	Non-traffic sensitive cost
	$10.9	*Billion total in NTS*		*$8.0*	
	$ 0.0161	per min	IXC	$ 0.0027	Traffic sensitive cost
	$7.6	*Billion total in TS*		*$1.3*	

All figures are approximate

Implications for access reform

- Current levels of SLC (even without PICC) are quite sufficient to recover the complete 25% interstate allocation of NTS FLEC ($9.1b SLC + $1.6b PICC vs. $8b NTS FLEC)
- Current levels of interstate per-minute charges (i.e., LS2, dedicated and common transport, signaling, RIC, etc.) recover about six times TS FLEC ($7.6b vs. $1.3b)

Summary

- FLEC is the appropriate cost concept for decision-making in dynamic, competitive markets
- Use of FLEC ensures rational decision-making for the complete collection of products offered by the telephone company
- FLEC can be flexibly and reliably estimated using proxy models of the underlying engineering and economic production processes
- FLEC of access is a small fraction of current charges